



20 October 2006

Dr John Tamblyn
Chair
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

Dear Dr Tamblyn

Review of Economic Regulation of Transmission Services – Forecast Expenditure

The Energy Networks Association (ENA) welcomes the opportunity to respond to the AEMC's request for further views on the decision-making requirements of the draft rule for regulation of electricity transmission services relating to assessing forecast expenditures.

Treatment of information provided outside of consultation process

The Commission's public consultation process on the draft electricity transmission revenue rule has involved over 55 submissions from interested parties, as well as public hearings with major stakeholders. A number of governments have participated actively in this process, with their views being taken into account by the Commission. The public consultation on draft provisions of the proposed rule has taken place over an eight month period, enabling views and assessments provided to the process to be independently and transparently tested.

The ENA notes that this further consultation is outside of that contemplated by the formal rule change process detailed in Sections 99-100 of the *National Electricity Law*. Parties with significant interest and direct expertise in the issues raised for further comment have only been provided with one week to provide a response to the range of matters contained in the AGS legal advice provided by the Commonwealth Department of Industry, Tourism and Resources to the Commission last week. For these reasons, energy network businesses would be extremely concerned if the Commission was to assign significant weight to this advice.

Response to AEMC questions released for further consultation

Energy network businesses continue to consider a requirement that the AER accept forecast capital and operating expenditures if the AER is satisfied that they represent reasonable estimates is an appropriate and balanced recognition of the potential risks and costs of regulatory error in this area of decision-making.

This approach provides meaningful practical incentives for regulated businesses to provide forecasts that are strongly evidenced and capable of acceptance. The wide range of factors the AER may have regard to, including past expenditure, its own analysis, and the evidence provided by the regulated business provides the AER with appropriate discretion to discount or reject forecasts that are not strongly supported by clear evidence.

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For these reasons network businesses consider that a decision rule that the AER must accept a proposal *where the AER itself is satisfied* that the forecast is a reasonable estimate is appropriate for inclusion in the AEMC's pending final determination. If the AER is satisfied on the basis of its own analysis and consideration of the guidance in the rules that an estimate is reasonable, scope for the AER to exercise residual discretion is unnecessary. Such residual discretion has the potential to significantly undermine the overall efficiency of the regulatory process.

Scope of AGS advice and relevance to AEMC final determination

In the view of energy network businesses the advice does not raise any substantive new issues that were not already previously raised by other parties and considered by the Commission in course of making its draft determination.

The advice provides a legal view on whether an alternative 'best estimate reasonably possible' criterion would result in greater discretion for the AER. The advice makes the uncontentious legal finding that there are a number of ways in which AER's discretion *could* potentially be widened.

The principal issue in a series of independent reviews of infrastructure regulation, however, is whether there *should* be wide discretion for an economic regulator to develop its own estimate of appropriate capital and operating expenditure programs, and reject reasonable estimates provided by the service provider on the basis that another value is preferred.

Resolution of this issue of regulatory design requires a broader economic assessment of the risks of potential under and over investment, together with expertise derived from the practical experience in infrastructure regulation to date. The AGS is poorly placed to offer relevant expertise on either of these key issues required to evaluate the question of what is the appropriate scope of regulatory discretion in assessing forecast capital and operating costs.

The broader expertise that has been available to a number of policy, rule making and administrative reviews has concluded that a regulator should not have the discretion to reject proposed expenditure forecasts that are reasonable, and substitute preferred values. These reviews have included the Prime Minister's Infrastructure Taskforce, the Productivity Commission *Review of the Gas Access Regime* and the AEMC's own position reflected in its recent draft determination.

The ENA's initial concerns with the scope the AGS advice and the policy implications of the implementation of alternative approaches are set out in Attachment 1.

Please feel free to contact me on (02) 6272 1555 if you have any queries relating to this letter, or wish to discuss any aspect of ENA's comments further.

Yours sincerely



Andrew Blyth
Chief Executive
Energy Networks Association



AGS opinion on assessment of expenditure forecasts

Background

This paper provides an assessment of the AGS legal opinion provided to the Commonwealth Department of Industry, Tourism and Resources dated 10 October on issues relating to the assessment of expenditure forecasts under the Australian Energy Market Commission's Draft Electricity Transmission Revenue Rule.

This paper examines:

- the scope and analysis contained in the opinion
- the operation of the alternative 'best estimate reasonably possible' decision criterion considered in the AGS opinion
- the policy implications of adopting the key findings of the opinion

Scope and analysis of opinion

Advice provides a legal opinion on a question of economic and rule-making judgment

A key deficiency in the potential application of the advice to future decisions on rule making is that it provides a legal opinion in response to an issue of economic and regulatory rule-making judgement.

For example, a question posed to the AGS is whether an alternative 'best estimate reasonably possible' criteria would result in greater discretion for the AER.¹ The advice makes the uncontentious finding that there are a number of ways in which AER's discretion could potentially be widened.

However, the principal issue in a series of independent reviews of infrastructure regulation is whether there *should* be wide discretion for an economic regulator to develop its own estimate of appropriate capital and operating expenditure programs, and reject reasonable estimates provided by the service provider on the basis that another value is preferred.

Resolution of this issue of regulatory design requires a broader economic assessment of the risks of potential under and over investment, together with expertise derived from the practical experience in infrastructure regulation to date. The AGS is poorly placed to offer relevant expertise on either of these key issues required to evaluate the question of what is the appropriate scope of regulatory discretion in assessing forecast capital and operating costs.

The broader expertise that has been available to a number of policy and administrative reviews has concluded that a regulator should *not* have the discretion to reject proposed expenditure programs that are reasonable, and substitute preferred values. These

¹ AGS Advice to Department of Industry, Tourism and Resources *Assessment of expenditure forecasts*, 10 October [para 2]

reviews have included the Prime Minister's Infrastructure Taskforce and the Productivity Commission *Review of the Gas Access Regime*.

The Australian Energy Market Commission has also formed the draft view supported by a wide range of stakeholders that a limited form of this approach, applying in a constrained way to the operating and capital cost elements of a pricing proposal, is appropriate to apply to electricity transmission revenue regulation. This view has been developed based on AEMC's wide economic and regulatory expertise through its staff and Commissioners, informed by its detailed consideration of the issues through the Chapter 6 review process. Through this process the AEMC has been guided by and has sought to apply the 'fit-for-purpose' model recommended by the MCE Expert Panel.

Opinion fails to consider wider requirements contained in the draft transmission rule which provide the AER with a clear discretion to reject inappropriate forecasts

The legal opinion considers a range of evidence regarding what may be assessed as a reasonable estimate and in determining the scope of discretion available to the AER. The important role of other provisions of the draft electricity transmission rule as guidance to the AER in interpreting and applying the 'reasonable estimate' test, however, is not fully acknowledged.

The legal opinion focuses on the guidance that the pricing principles and market objective, together with the twelve factors under 6A.6.6 may provide. Equally important, however, are the requirements that will surround and define an electricity transmission business's proposal. The advice does not contain any significant analysis of the implications of these broader requirements for its conclusions.

Key elements of the rules not considered by the opinion include:

- a requirement to comply with an *information guideline* prepared by the AER setting out the information required to assess proposals
- a requirement to comply with a *submission guideline* prepared by the AER detailing the form of a proposal and the information which a proposal must contain
- a requirement to comply with a *cost allocation methodology* to ensure comparability of cost reporting information through time
- an ability for the AER to reject a proposal which fails to comply with the requirements of the rules and relevant guidelines
- provision for *certified annual statements* to be provided by the business to the AER
- powers for the AER to require additional information necessary as an input to regulatory decision-making
- scope for AER to undertake independent verification or auditing of any information sought or provided

The extensive nature of these requirements is an important underpinning to the AEMC's decision to adopt a limited propose-respond approach to capital and operating costs.

This is because the wider decision-making framework outlined above ensures that the AER will be well placed to make an informed assessment of whether a reasonable estimate has been provided. This 'balancing' framework is not considered in the advice. Clearly, without this strong package of protections relating to informed regulatory

decision-making, the AEMC would have been reluctant to adopt the constrained propose-respond decision criterion currently in the draft rules.

Opinion makes unsupported claims on effects of the pricing principles and objectives

The legal opinion briefly considers the role of the objectives and pricing principles on the exercise of regulatory discretion, positing that the pricing principles in particular would favour the view that a 'broad range' of proposals may fall within the bounds of a reasonable estimate.² This conclusion, however, appears to put considerable weight on a questionable interpretation of these principles.

The NEL pricing principles require that businesses must be provided with a 'reasonable opportunity' to recover at least the efficient cost of providing electricity services. The AGS advice appears to interpret these pricing principles as resulting in infrastructure service providers being largely guaranteed the recovery of their costs, and the protection of their commercial interests. This interpretation ignores several key points:

- the AER is only required to provide a '*reasonable opportunity*' for the recovery of efficient costs - regulated charges do not necessarily need to provide certain recovery of actual or efficient costs
- prices are to be based on an AER assessment of '*efficient costs*' - that is, prices may not necessarily allow the recovery of even the actual costs of providing the relevant services
- this pricing principle is to be taken into account alongside other principles such as ensuring the efficient operation and use of infrastructure.

In this context, and in the absence of any interpretation of the pricing principles by a Court or administrative review body, the claim underpinning the advice that the pricing principles would favour the acceptance of a service provider's proposal is speculative and potentially misleading.

The NEL objective is focused on achieving the long term interests of *consumers*, facilitating this objective by virtue of encouraging the efficient operation and use of electricity services, and also referencing the promotion of efficient investment. Similar references to efficiency of operation and use of infrastructure, and requirements for the AER to take into account the potential risks and costs of underutilisation of assets and overinvestment do not support the contention made in the opinion that the pricing principles or objectives are unbalanced in the manner suggested.

The development of the market objective also supports this interpretation, given the policy decision by MCE to require the specific referencing of the interests of consumers in the objective, requiring a modification of an objects clause originally proposed by the Productivity Commission *Review of the Gas Access Regime* for the gas regime.

² AGS Advice to Department of Industry, Tourism and Resources [49-52]

No evidence to support the contention underpinning the opinion that a propose-respond framework in gas has led to distorted or inefficient pricing outcomes

The legal advice contends that the decision-making standard of ‘reasonable estimate’ has the potential to lead to outcomes that are distorted or inefficient.³ No objective evidence from the operation of the gas access regime is examined to support this claim. If a ‘propose-respond’ approach based on the AEMC’s ‘reasonable estimate’ framework was to be introduced the clearest guidance to the likely operation of this model would be decision-making under the current regulatory model in gas. Current relevant national electricity regimes contain a consider-determine framework in relation to total revenue proposals, with an unrestricted capacity for the regulator to substitute their ‘best estimate’ of forecast expenditure.

The ENA has examined the difference between draft and final revenue determinations across Australian distribution networks using the published decisions of regulators. The purpose of this is to establish whether the propose-respond approach in place under the National Gas Code, as detailed in the advice, has resulted in any discernible upward bias in regulatory decision-making surrounding allowable revenues. The analysis below is based on the differences between draft and final total revenue determinations made under the electricity and gas regimes (See Table 1 & 2).

Table 1 Electricity distribution pricing determinations – draft and final revenues

Service provider	% increase of allowable total revenues from draft and final determinations
ActewAGL	4.9
AGL Electricity	9.8
Aurora Energy	N/A
Citipower	16.3
Country Energy	4.5
EnergyAustralia	0.2
ENERGEX	4.5
Ergon Energy	1.1
ETSA Utilities	20.4
Integral Energy	5.0
NT Power & Water	N/A
Powercor	7.5
SP Ausnet	6.2
United Energy Distribution	4.3
Average - electricity distribution	7.0

The analysis shows that on average final revenue determinations under a ‘best estimate’ consider-determine framework increase from those provided for under draft determinations by around 7.0 per cent. That is, regardless of any estimates of required revenues made by network businesses, regulators on average consider an upward movement of approximately 7.0 per cent is required for a sound and balanced decision.

³ AGS Advice to Department of Industry, Tourism and Resources [53]

Table 2 Gas distribution pricing determinations – draft and final revenues

Service provider	% increase of allowable total revenues from draft and final determinations
ActewAGL	-17.4
AGL Gas Networks	0.6
AlintaGas Networks WA	0.9
Country Energy	3.1
ENERGEX (Allgas)	11.7
Envestra SA	9.9
Envestra Qld	16.7
Envestra Vic	1.9
Multinet Gas	7.8
SP Ausnet	4.9
Average - gas distribution	4.0

Table 2 illustrates that the difference between initial and final assessments of required revenue under the Gas Code's propose-respond approach are narrower. This evidence is not consistent with the proposition that a propose-respond approach in respect of capital and operating forecasts would result in the AER being required to accept proposed forecasts that are excessive, not justified or inefficient. In fact, the evidence is more consistent with the proposition that a 'best estimate' consider-determine approach to setting key elements of allowable revenues is likely to result in less accurate or predictable regulatory decision-making.

Advice shows 'reasonable estimate' is a clear criteria with a well-understood meaning

The legal analysis of the term 'reasonable estimate' makes clear that the AER will have, under the AEMC's proposed rule, discretion to reject forecast costs which are excessive, unsustainable or which cannot be justified with reference to sound evidence.⁴

The advice also demonstrates that the AER and administrative review bodies have an existing body of precedents and other evidence to inform decisions surrounding what constitutes a 'reasonable estimate'.⁵ Indeed, at least one State-based regulatory body has sought to apply a 'reasonable estimate' criterion in its own determinations on final price and tariff movements in electricity distribution services.⁶

In contrast, the legal opinion does not consider at any length the potential application of the 'best estimate reasonably possible' test, presumably because there is an absence of any guidance as to how the AER and administrative review bodies could apply this new decision criterion.

⁴ AGS Advice to Department of Industry, Tourism and Resources [33-43]

⁵ AGS Advice to Department of Industry, Tourism and Resources [20-42]

⁶ See IPART Final Electricity Determination (2004), pp.21, 129-130 <www.ipart.nsw.gov.au>

Assessing the ‘best estimate reasonably possible’ criteria

Alternative decision criteria of ‘best estimate reasonably possible’ is a flawed assessment criteria

As the advice sets out the ‘best estimate reasonably possible’ decision criteria is potentially different to the ‘reasonable estimate’ test. The criterion is also different to the criterion in the current Gas Code of ‘best estimate on a reasonable basis’. There is no certainty around the application of ‘best estimate reasonably possible’ as it represents a new test with no relevant regulatory practice.

A number of practical issues arise in interpreting the concept of a best estimate. For example:

- on what basis is an estimate judged to be ‘best’ - does this term incorporate concepts of a probabilistic or statistically ‘expected value’, or more qualitative considerations?
- If the phrase ‘best estimate’ is to be interpreted qualitatively, how well placed is a regulator to make this judgement that will rely on business-specific factors, and potentially complex series of scenarios and potential cost tradeoffs?
- how can a regulator arrive at judgements about a single ‘best’ estimate where there may be a number of equally probable scenarios implying markedly different operating and capital programs (such as a high, low and medium demand scenarios)?
- how does the criterion apply in situations where there are a number of reasonable basis’s or methodologies which may produce different ‘best’ estimates?
- how does the concept of ‘reasonably possible’ differ from ‘on a reasonable basis’?
- how is assigning to a regulator the task of assessing whether a proposed estimate equals a ‘best’ estimate a more realistic or achievable for a regulator with no direct commercial experience of the design and nature of capital and operating expenditure programs than the task of making an informed assessment of whether an estimate is reasonable?

The AGS opinion provides no guidance on these issues. As such it represents an incomplete and uncertain basis for regulatory decision-making which should not be included in either the AEMC’s final rule determination or future distribution rules.

Energy network businesses, that will have to directly apply these provisions, have no confidence in the modified ‘best estimate’ approach

In submitting capital and operating cost forecasts network businesses need a clear and achievable standard. ‘Reasonable estimate’ is such as standard, however, there is no clarity over the standard of forecasting which would satisfy the modified ‘best estimate reasonably possible’ test.

The AGS opinion incorrectly presumes that the key stakeholder in applying these criteria will be the AER. In the first instance it will actually be network businesses’ task to

interpret these rules in preparing forecasts to be assessed by the AER. Due to the uncertainties and lack of guidance surrounding the possible interpretation of the 'best estimate reasonably possible' criterion detailed above, energy network businesses lack confidence in the modified approach raised in the advice.

Adoption of the modified test in the opinion would potentially lead to greater scope for disputes, and more appeals

The advice sets out a clear assessment based on Australian Competition Tribunal precedents as to how the concept of a reasonable estimate will be interpreted. In contrast the term 'best estimate reasonably possible' is new, and its meaning is likely to be only able to be established over time. Necessarily, if a 'best estimate reasonably possible' criteria were adopted much of the precedential material described in the AGS advice as establishing a likely interpretation of the term 'reasonable estimate' will not be relevant. The opinion itself contains no substantive legal analysis over possible interpretative approaches to the term 'best estimate'. In particular, the advice provides no guidance on any of the practical interpretive issues previously outlined.

While the advice examines the potential interaction of the 'reasonable estimate' criteria and a merits review mechanism, a robust evaluation is not conducted for the alternative 'best estimate' criterion. The Australian Competition Tribunal and Federal Court have made a number of recent decisions regarding the scope of a regulator's discretion in circumstances where they are substituting values, following rejection of a service provider's Access Arrangement.⁷

Broadly, this is held to be a wide discretion with the regulator 'at large' to substitute their own values consistent with the rules. It is important to recognise differences in the operation of this stage of merits review in circumstances where the AER is required to substitute a 'reasonable estimate' (current AEMC draft rule) compared to a position where the AER must substitute a value which can be evidenced at any appeal as a 'best estimate reasonably possible'.

The 'best estimate' criteria allows potentially wider scope for administrative review of AER decisions substituting capital and operating cost forecasts, since it would be easier for the AER to establish if its decision is challenged that the value it has substituted is a 'reasonable estimate' than it would be to satisfy the Australian Competition Tribunal that it is the 'best estimate reasonably possible'. It is doubtful that the Tribunal or Court could hold that the AER was equally 'at large' to substitute a forecast value where the standard required of this substitutive decision was explicitly specified in rules, and where this was that 'best estimate reasonably possible' rather than a 'reasonable estimate'.

Opinion reinterprets and substantially modifies decision criteria preferred – but not actually recommended – by the MCE Expert Panel.

The alternative formulation is a modification of the existing test for forecasts under the Gas Code and the formulation preferred, but not recommended, by the MCE Expert

⁷ See *ACCC v Australian Competition Tribunal* [2006] FCAFC 83, 2 June 2006

Panel. Under the Gas Code the regulator must be satisfied that *'any forecasts required in setting the Reference Tariff represent best estimates arrived at on a reasonable basis'*.⁸

The alternative formulation considered is that the regulator should be required to be satisfied that any forecast capital or operating costs are the *'best estimate that are reasonably possible in the circumstances'*.

Implementing the modified criteria included in Question 6 and briefly discussed in 1.5 pages of the opinion would not be implementing the outcomes of the MCE Expert Panel, it would be adopting a new decision criterion. The Expert Panel made no findings that the application of a 'reasonable estimate' test in relation to capital or operating cost forecast would be inappropriate.⁹ The MCE Expert Panel 'preferred' but did not recommend the criteria established in Section 8.2(e) of the Gas Code ('best estimates on a reasonable basis').

The modified criterion materially differs from this formulation, on the basis of the AGS's *opinion* of the intention of the MCE Expert Panel. It is unclear what basis the AGS makes a judgement that when the Expert Panel recommended 8.2(e) as the preferred criteria that it 'meant' something different and close to the modified decision criteria.¹⁰ There is no evidence in the relevant analysis in the Expert Panel's draft or final reports to support this interpretation.

The advice appears to be based on a presumption that the Expert Panel adopted a particular interpretation of the 'best estimates on a reasonable basis' which it stated that it 'preferred'. This presumption is used to support a modification of this test. Reviewing the MCE Expert Panel report, it is unclear which elements have been relied on to support a modification of the existing Gas Code test. There are no comments in the Expert Panel report to indicate that they prefer a modification to the wording in line with the proposed alternative formulation.¹¹ Indeed, given the Expert Panel directly reference the Gas Code provision, the opposite presumption would be more likely.

Implications of the adoption of the alternative decision criteria

Adoption of the alternative decision criteria would have a number of implications.

Implication 1

Confidence in the commitment by Australian governments to a separate independent rule-making process informed by an expert regulatory rule-making body – the Australian Energy Market Commission – would be undermined

This would lead to market participants lacking confidence that the independence of any future rule-making processes would be respected by governments, and that expert assessments made by the Commission would not be 'second guessed' by Ministerial Council on Energy processes.

⁸ See National Gas Code Section 8.2(e)

⁹ See Expert Panel on Energy Access Pricing *Report to Ministerial Council on Energy*, April 2006, p.89-92

¹⁰ AGS Advice to Department of Industry, Tourism and Resources [64]

¹¹ See Expert Panel on Energy Access Pricing *Report to Ministerial Council on Energy*, April 2006, p.83

Implication 2

Introducing a divergent test would introduce an untested decision criterion which had not been transparently assessed

This would substantially increase regulatory risk. There would be a net increase in the level of uncertainty associated with the adoption of an entirely new decision criteria standard.

Implication 3

Following the opinion would potentially deliver separate and inconsistent assessment criteria across the energy sector

It is likely that the decision criteria for equivalent regulatory decisions would be different between electricity transmission and electricity distribution, with both of these also being potentially different from the approach applying to gas transmission and distribution.

These different criteria would be likely to distort investment and regulatory outcomes between gas infrastructure, and between electricity transmission and distribution.

Differences in the decision-making standard between distribution and transmission would invite a distortionary approach to the approval of required investment transmission and distribution infrastructure. In many cases, this discriminatory treatment would be applied to assets which are identical in nature and function.

Implication 4

Following the opinion would effectively deliver a 'consider-determine' model across all major elements of electricity transmission rules, contrary to the MCE's decision to adopt a 'fit-for-purpose' approach

The MCE made a decision to adopt a fit-for-purpose model which is characterised by use of elements of consider-determine and propose-respond across different parts of the assessment of an access proposal. The AEMC has explicitly worked to this model, incorporating elements of both into its Chapter 6 rules. The assessment of capital and operating expenditure under a 'reasonable estimate' test was one of the few areas of the Chapter 6 rules that utilise the propose-respond framework, given the strong case that a business is better placed to estimate potential future capital and operating programs. Reversal of this position by the effective imposition of a 'consider-determine' approach would shift the overall package to an almost completely 'consider-determine' framework. This is contrary to the MCE's stated intention of developing a fit for purpose regulatory approach.¹²

¹² Ministerial Council on Energy, Communiqué, May 2006